

## The New Horizon of the Alternate Basic Tax

During the last few days, the alternate basic tax ("ABT") that applies to individuals in certain circumstances under the provisions of the Puerto Rico Internal Revenue Code of 2011, as amended (the "New Code") as well as the corresponding tax consequences of flow-through entities have been subject to numerous discussions and consultations. As a result, on Friday March 30<sup>th</sup>, the Puerto Rico Treasury Department ("Treasury") issued Administrative Determination Number 12-08 ("AD 12-08") to clarify the issues. In the following paragraphs we summarize the most relevant aspects of AD 12-08 related to the ABT.

### BACKGROUND

The ABT is a parallel computation of tax, intended to capture net taxable income in a broader sense. Accordingly, it not only includes some income not otherwise taxable but also disallows certain deductions. Under the New Code, the most controversial addback for ABT purposes relates to certain trade or business expenses incurred by individuals and flow-through entities. Prior to AD 12-08 expenses such as professional services, bad debt, advertising and interest, amongst others, were disallowed for ABT purposes. As a result of these addbacks, a lot of taxpayers confronted the possibility of having their effective tax rates increase significantly.

### AD 12-08

Treasury determined that, subject to compliance with certain requirements, the following trade or business expenses that are incurred by a self-employed individual or a flow-through entity (i.e., special partnership or corporation of individuals) constitute deductible expenses in order to determine the Net Income Subject to ABT.

- Professional Services** - This deduction will be allowed for ABT purposes if the expense is duly reported in an informative return such as Informative Return - Income Not Subject to Withholding (Form 480.6A), Informative Return - Income Subject to Withholding (Form 480.6B) or Informative Return - Income Subject to Withholding-Non Residents (Form 480.6C), as applicable, and the corresponding income tax withholding, if any, has been made.

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In order to avoid an addback for ABT purposes, individuals claiming professional service expenses must report them as salaries instead of as professional services on Annexes K, L, M, or N of the return, whichever applies. In the case of a flow-through entity, such expenses should not be reported as an adjustment to the Net Income Subject to ABT of the partner or stockholder that is an individual.

**2. Fringe Benefits Paid to Employees -**

Expenses paid to employees of a trade or business as fringe benefits, such as payments made to cover medical insurance premiums, the employer contribution to retirement plans, and employee benefits qualified plans are considered allowable deductions for purposes of determining the Net Income Subject to ABT, as these are considered to constitute part of the compensation of such employees.

In order to avoid the addback for ABT purposes, these expenses must be reported in the line corresponding to "payroll expenses" in Annexes K, L, M, or N.

In the case of flow-through entities, these deductions will not be considered as an addback for purposes of the determination of the ABT of its shareholders or partners.

**3. Motor Vehicles Expenses -** The New Code distinguishes between two types of motor vehicles: automobiles and other motor vehicles.

There are conditions and limitations on the depreciation expense of automobiles, as well as limitations related to their use and maintenance. The term "automobile" includes any motor vehicle manufactured for transit on public ways and designed to transport people, except those used directly in the transportation of passengers or properties through compensation or payment, such as limousines, taxis or public vehicles, funeral cars, ambulances, trucks and any other similar vehicle used mainly in the transportation of freight.

AD 12-08 clarifies that the expenses for depreciation, use and maintenance of motor vehicles that are not automobiles, for example, expenses of freight vehicles for the distribution and delivery of goods or services, funeral cars or ambulances, will be deductible, without limitation, for purposes of determining the Net Income Subject to ABT. On the other hand, expenses for the use or maintenance of automobiles will be deductible for purposes of the ABT up to the limitation established in the New Code.

In order to avoid the addback for ABT

purposes, these expenses must be reported in the line corresponding to property taxes or other taxes (subject to the inclusion of an Exhibit with the details) of annexes K, L, M, or N.

**4. Rents and Royalties -**

The payments of rents and royalties include, in addition to those made for the use of tangible personal or real property, payments made for intangible property, such as royalties, patents, franchises or licenses, when these are made as a condition to continue using the intangible property in the trade or business will be considered as vehicle deductions for ABT purposes provided they are duly reported on the corresponding informative return and that the applicable income tax withholding under the New Code has been made.

In order to avoid the addback for ABT purposes, these expenses must be reported in the line corresponding to "rents paid" in annexes K, L, M, or N, provided a schedule is attached submitting the necessary information.

**5. Indispensable Direct**

**Costs -** Furthermore, expenses that constitute an Indispensable Direct Cost for the rendering of the services or to carry out the industry or business will also be considered as valid deductions for ABT purposes. An expense

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will be considered that is an Indispensable Direct Cost for the rendering of the services or to carry out the industry or business only if the same is an essential element of such service on industry. Examples of these expenses are:

- a. Malpractice insurance premiums as well as insurance premiums on inventory or other personal or real property used in the trade or business.
- b. Marketing and advertising expenses incurred by businesses that are devoted to the sale of consumer goods or services, including retail stores or wholesalers, restaurants and other similar businesses.
- c. Interest on debt incurred for the acquisition of inventory or other personal or real property used in the trade of business.
- d. In the case of taxpayers under the accrual method of accounting, the

write-off of uncollectible accounts receivable derived from the sales of goods or services for the industry of business.

- e. Expenses for advertisements in radio, newspaper, on television made by an advertising agency, which are part of the cost of the service rendered.
- f. The payments made by travel agencies to airlines, hotels, cruise ships, and other industry suppliers as part of the services that offer such agency.

It should be noted that the limitations established by the New Code on the nondeductible items to determine the net income subject to regular tax are also applicable to determine the Net income Subject to ABT. It is important to point out that the following expenses do not constitute Indispensable Direct Costs under any circumstances:

- i. travel, meals and entertainment expenses;
- ii. representation or public relations expenses; and
- iii. lobbying expenses.

In order to avoid the addback for ABT purposes, these expenses must be reported in the line corresponding to property taxes of annexes K, L, M, or N. The taxpayer must include with the return an annex detailing the nature and amount of the items claimed as a deduction for Indispensable Direct Costs.

On the other hand, with regard to those individuals that are partners or stockholders of a flow-through entity, they should include in their tax returns the corresponding adjustment of those items of income and expenses derived by the flow-through entity that, in the hands of the individual, are items subject to ABT.

**COMMENTS**

AD 12-08 has a significant positive impact on the determination of the ABT for individuals. This is done by expanding the definition of valid trade or business expenses in a way that fairly addresses the concerns of business people across industries. One of the aspects that should be kept in mind is the definition of the term "Indispensable Direct Cost" as it is not defined in the New Code. You may have a situation in which an item of expense is significant and it may be considered as an Indispensable Direct Cost

since it is essential for the taxpayer's trade or business. If this were the case, our recommendation would be to request a ruling to Treasury to confirm that such expense qualifies as an Indispensable Direct Cost. Now, taxpayers must analyze their tax situation considering this AD 12-08 to determine if the ABT will affect them.

Partners and stockholders of a flow-through entity that has a taxable year other than December 31 should make a computation to determine the Net Income Subject to the ABT. The reason is that flow-through entities with fiscal years ended in 2011 on a month prior to December will not be subject to the New Code until 2012. Therefore, if the individual elects the New Code for his/her 2011 return, the flow-through entity must elect the New Code instead of Option 94 for the fiscal year ending in 2012.

On the other hand, the AD 12-08 also provides an additional time to request a retroactive revocation of the elections of corporations of individuals and special partnerships, if this is necessary. We will discuss the consequences of these possible revocations in a subsequent article.

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